

THE INVESTMENT TAX CREDIT

by

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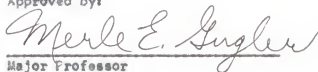
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INTRODUCTION

The investment credit is a taxation device employed by the Administration and Congress of the United States to encourage domestic industry to modernize and expand its productive facilities. This "credit" is a reduction of the taxes otherwise payable, and is earned when certain qualified assets are acquired and used. Some have questioned the advisability of the United States Government's role in subsidizing domestic industry by means of this "credit." A fear of "creeping socialism" tends to provoke criticism whenever the Federal Government provides aid to any segment of the economy.

However, economic justifications for enacting the investment tax credit can be cited. The productive facilities of Europe and Japan were almost completely destroyed during World War II. Following the cessation of hostilities, the United States was instrumental in rebuilding the productive facilities of these countries through extensive foreign aid programs. Because the productive facilities that were rebuilt in these countries incorporated the latest technological knowhow, they are, in many instances, more modern and efficient than similar facilities in the United States.

The United States enjoyed a virtual monopoly in world trade immediately following World War II, but has faced stiff competition in the last few years. Most of this competition has come from Germany, England, France, Italy and Japan, all of which were among the countries that accepted aid from the United States in rebuilding their productive

facilities after World War II. Many of these countries provided laws to encourage their industries to keep their productive facilities modern, even before the United States considered such a step. It would therefore appear that the provision of this investment credit was unquestionably an appropriate step for our Administration and Congress to take.

The investment credit was enacted in the Revenue Act of 1962, that was passed by the Congress on October 16, 1962.¹ It has been described as the most substantial tax legislation since 1954.² The essential features of the law provide that the credit is to be taken against Federal income tax. The maximum credit is equal to 7% of the cost of new equipment purchased. The 7% investment credit is assigned according to the useful life of the property as follows:

<u>Proportion of 7%</u>	
less than 4 years	None
at least 4, but less than 6 years	1/3 or 2.3%
at least 6, but less than 8 years	2/3 or 4.7%
8 years or more	7%

The credit will reduce the depreciable basis of the property (note--this provision was eliminated by a subsequent change which will be discussed later). The unused credit may be carried back or forward. The amount of the credit must be repaid to the government, on a pro rata basis, if the property is not held by the taxpayer for its full useful life.

¹Public Law 87-934, 87th Congress, H.R. 10650, (1962), p. 3.

²Dale D. Baker, "Principle Features of the Income Tax Credit for New Investment," NAA Bulletin. April 1963, 44:13.

The purpose of this paper is fourfold: (1) To state the controversy over the investment credit that arose among practicing accountants; (2) to examine these arguments with respect to the intent of the Administration and Congress in writing the law; (3) to analyze the methods utilized by corporations in accounting for the investment credit as originally provided for, and (4) to explain the major changes in the law and how they will change the accounting for the credit by corporations.

The investment credit is a new law. Accounting texts currently available do not present a comprehensive treatment of this subject. In order to gain a thorough understanding of the subject, one must therefore rely on the sources that will form the basis for the procedures that will eventually be included in the textbooks. Examples of these sources are: periodical professional publications, newspaper and magazine articles, unpublished speeches and studies by experts in the field, U. S. Government publications, public accountants, tax attorneys, and representatives of the U. S. Internal Revenue Service. These are the sources from which the material for this report has been gathered.

This study is primarily concerned with the business corporation's treatment of the major provisions of the investment credit law. Examples are also used to illustrate the treatment of the credit by lessors and lessees, partnerships, and the small business corporations. Accounting for the credit by public utilities is not included. However, information published by public utility corporations, and by Federal agencies, has been studied for background information. Except for the

smaller percentage of credit allowed the public utilities, their treatment of the investment credit is essentially the same as that practiced by commercial corporations. It therefore would have been repetitious to have included public utilities in this report.

THE INTENT

In April, 1961, President Kennedy proposed an incentive, in the form of a tax credit, to encourage the modernization of plant and equipment. The President stated:

...the tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment. It will stimulate investment in capacity expansion and modernization, contribute to the growth of our productivity and output, and increase the competitiveness of American exports in the world markets.¹

In a joint conference report, the Senate and the House of Representatives stated in regard to the investment credit:

It is the understanding of both the House and the Senate that the purpose of the credit for investment in certain depreciable property ...is to encourage modernization and expansion of the nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over their productive lives.²

A clearer statement of legislative intent is difficult to find. Furthermore, the law, as finally passed, states clearly that the credit

¹Economic Report of the President, 1962, p. 26, H.R. Doc. No. 278, 87th Cong., 2nd Sess. (1962) Hearings, Part., p. 83.

²House of Representatives, Report No. 2508, 37th Cong., 2nd Sess. (1962), p. 14.

is contingent upon the taxpayer holding and using the new productive equipment. The penalty for failure to comply is the repayment of the credit to the government, on a pro rata basis, based upon the time the equipment was actually used. This penalty provision emphasizes the intent, i.e., to reduce the cost of acquiring new facilities, and to increase their profitability over their productive lives.

The question might be raised as to whether legislative intent should have anything to do with accounting for the investment credit. Normally accountants prefer that their procedures not be dictated by any governmental agency, but that they be based upon underlying postulates and principles. However, it is obvious that the proper accounting treatment of any transaction is dependent upon the cause or reason for the particular transaction. For example, to properly account for the receipt of a sum of cash we must know if the cash came from a sale, was received on accounts receivable, represents a cash loan, or something else. In this sense it would appear that the legislative intent must be considered in accounting for the investment credit. This intent was made perfectly clear by the joint report previously referred to.¹

After careful consideration of the Revenue Act of 1962, the Accounting Principles Board issued its Opinion No. 2 which dealt with the accounting for the investment credit. This opinion stated in part:

¹loc. cit.

13. We conclude that the allowable investment credit should be reflected in net income over the productive life of acquired property and not in the year in which it is placed in service.¹

In explaining the basis for its conclusion, the Accounting Principles Board stated:

12. In concluding that the cost reduction concept is based upon existing accounting principles, we attach substantial weight to two points in particular. First, in our opinion, earnings arise from the use of facilities, not from their acquisition. Second, the ultimate realization of the credit is contingent to some degree on future developments. When the incidence of realization of income is uncertain, as in the present circumstances, we believe the record does not support the treatment of the investment credit as income at the earliest possible point of time. In our opinion the alternative choice of spreading the income in some rational manner over a series of future accounting periods is more logical and supportable.²

It would appear that the decision of the Accounting Principles Board was clearly in consonance with the intent of Congress. However, it added more fuel to controversy that already existed. By the time the smoke had cleared somewhat, it was recognized that uniformity in accounting for the credit would not be achieved by the board's opinion. Despite the board's opinion, three of the "Big Eight" accounting firms had announced that they would not be bound by that pronouncement, contending that alternative treatment of the credit should be permitted,³ namely immediate flow through to income (100%). The Securities and

¹Opinions of the Accounting Principles Board, "Accounting for the Investment Credit," December, 1962, p. 6.

²Loc. cit.

³G. Barratt, address before the North Central Chapter of the Arizona Society of CPA's, February 13, 1963.

Exchange Commission had announced that it would accept either the board's position, or immediate recognition of the after-tax portion (43%) of the credit as income.¹

Other methods of accounting for the credit were advocated, some by various regulatory bodies. However, the three mentioned above gained the widest acceptance and are the ones with which this paper will be primarily concerned.

After observing for some months the various methods employed in accounting for the investment credit, the Accounting Principles Board issued another opinion on this subject in March, 1964. The new conclusions of the board state in part:

9. However, the authority of Opinions of this Board rests upon their general acceptability. The board, in the light of events and developments occurring since the issuance of Opinion No. 2, has determined that its conclusions as there expressed have not attained the degree of acceptability which it believes is necessary to make the opinion effective.

10. In the circumstances the Board believes that, while the method of accounting for the investment credit recommended in paragraph 13 of Opinion No. 2 should be considered to be preferable the alternative method of treating the credit as a reduction of Federal income taxes of the year in which the credit arises is also acceptable.²

Needless to say, this opinion did nothing toward achieving uniformity in accounting for the investment credit. Rather, it probably encouraged further disregard for the opinions of the board. However, it

¹"Institute and SEC Positions on Investment Credit," The Journal of Accountancy, February, 1963, 115:11.

²Opinions of the Accounting Principles Board, "Accounting for the Investment Credit," March, 1964, p. 22.

is perhaps significant to note that five members of the board dissented to Opinion No. 4, whereas six members dissented to Opinion No. 2. The views of those dissenting from this latest opinion were perhaps most succinctly stated by Mr. Leonard Spacek of Arthur Andersen & Co., who stated in part:

...there is no justification for sanctioning two contradictory practices to accommodate SEC and other regulatory bodies and some CPA's who have approved reporting the investment credit as, in effect, profit from acquisition rather than from use of property. This flouts Congress' clear intent in granting the investment credit, 'to reduce the net cost of acquiring depreciable property' ...¹

THE LAW

The Revenue Act of 1962

The Revenue Act of 1962 provided that the amount of the investment credit should be equal to 7% of the qualified investment. Qualified investment was defined as tangible personal property, and certain other tangible property, (not including a building and its structural components), which is depreciable and has a useful life of four or more years. As previously indicated, the 7% investment credit is assigned according to the useful life of the property as follows:

	<u>% of 7%</u>
less than 4 years	0%
at least 4 years, but less than 6 years	33 1/3%
at least 6 years, but less than 8 years	66 2/3%
8 years or more	100%

¹Ibid., p. 24.

For example, an investment of \$1000 in qualified property, having a useful life of 9 years would qualify for \$70 investment credit ($\$1000 \times .07$). If the useful life were 6 years, the credit would be \$46.67 ($\$70 \times 66 \frac{2}{3}\%$), if 4 years, \$23.33 ($\$70 \times 33 \frac{1}{3}\%$). The law provided that the investment credit would be limited in any single year to \$25,000 plus $\frac{1}{4}$ of the tax liability in excess of \$25,000. Any credit not allowed because of the limit may be carried back for three years or forward for five, with the unused credit being applied to the earliest year first. Used property can also qualify for the investment credit, but is subject to a \$50,000 limit. The law also prescribed that in the event the property was disposed of before the expiration of the useful life, the tax liability for the year of disposition would be increased by the entire amount of the unearned investment credit.

In addition to reducing the tax liability, the 1962 law provided that the depreciable basis of the property would be reduced by the full amount of the investment credit. This reduction was required even though the tax limitation prevented the full application of the credit.¹ Because of this reduction of the depreciable base by the amount of the investment credit, the credit resulted in a net tax savings of 43% of the 7% credit, assuming a corporate tax rate of 52%. For example, if \$100,000 were invested in qualified property, the tax liability would be reduced by \$7,000 in the year of investment ($\$100,000 \times .07$). Similarly, the depreciable basis would be reduced from \$100,000 to

¹Kenneth B. Berg and Fred J. Muller, "Accounting for Investment Credits," Accounting Review, July, 1963, 38:554.

\$93,000 which would result in \$7,000 more net income over the life of the property than would have been true without the investment credit. Consequently, the tax liability would be increased over the useful life by \$3,640 ($\$7,000 \times 52\%$), and the after-tax income would be increased by only \$3,360 ($\$7,000 \times 48\%$). It is interesting to note that the net increase in after-tax income over the useful life of the property is the same regardless of the method used to account for the investment credit in the non-tax financial statements. The only difference is the period over which the tax saving is recorded in the statements. Three basic methods have been employed to accomplish this. These methods have been well explained in McKenzie's Master's Report¹ and will be but briefly described herein:

The "full-deferral" or "cost reduction" method. The asset is written down by the amount of the investment credit for book, as well as for tax purposes. The 7% credit is spread evenly over the life of the asset by increasing the earnings each year.

The "48-52%" or "partial-deferral" method. Based on a 52% corporate tax rate, advocates of this method say that 48% of the credit amounts to a tax cut and should be reflected as a reduction of tax expense in that year. The remaining 52% is amortized annually against tax expense over the life of the asset.

¹Patrick B. McKenzie, "Initial Accounting for the Investment Credit by Corporations," Kansas State University Master's Report, 1964, p. 8.

The "100% flow-through" or "no-deferral" method. The full credit is reflected as additional earnings in the year the credit is taken.

The Revenue Act of 1964

Depreciable Basis No Longer Reduced. A major change contained in the new act was the repeal of the requirement that the depreciable basis of qualified property be reduced by the amount of the investment credit for property placed in service on or after January 1, 1964. It also provided that, for property placed in service before January 1, 1964, the depreciable basis would be restored to its original value.¹ As a result of this change, the full amount of the investment credit is realized as income, rather than only the after-tax portion. It appears entirely possible that the former advocates of the "43-52%" or "partial-deferral" method will now support the "100% flow-through" or "no-deferral" method since the former basis for their flowing through to income in the year of acquisition only the 43% remaining after tax has now been eliminated. However, since there has been nothing to indicate a change in the intent of Congress in providing the investment credit, the "full-deferral" advocates will probably remain firmly in support of their method.

To illustrate the initial accounting entry to record the investment credit for property placed in service after January 1, 1964, assume that, on January 2, 1964, \$1,000,000 is invested in qualified machinery and equipment with an estimated useful life of 10 years.

¹House of Representatives, Report No. 3363, 88th Cong., 1st Sess. (1964), p. 15.

The accounting entry will remain the same under the "flow-through" method, as follows:

Dr. Taxes Payable	\$70,000
Cr. Income Tax Expense	\$70,000

(To reduce the Federal income tax liability to the amount actually payable after the full amount of investment credit has been taken in the year the asset is placed in service.)

However, under the "full-deferral" method, a new initial entry will be required, as follows:

Dr. Taxes Payable	\$70,000
Cr. Deferred Credit	\$70,000

This entry does not decrease the income tax expense in the year of acquisition from what it would have been without the investment credit, and sets up the credit as a deferred item to be amortized over the life of the asset, in this case 10 years. By annual amortization entries, the deferred credit will be spread over the life of the asset, as follows:

Dr. Deferred Credit	\$7,000
Cr. Income Tax Expense	\$7,000

Entries to record the annual depreciation will be made without regard to the investment credit for property placed in service after January 1, 1964, i.e., normal depreciation entries. However, in the case of qualified property that had been placed in service prior to January 1, 1964, special treatment will be required. Assume a qualified investment of \$1,000,000, placed in service in 1962, with an estimated useful life of 10 years. Because of the law in effect in 1962, the depreciable basis for 1962 and 1963 was reduced by the \$70,000 investment credit to \$930,000. On this basis, depreciation expense was recorded at \$93,000 per year. The new law provides that the depreciable basis will be

\$1,000,000 and that the depreciation not claimed under the old basis will be recaptured over the remaining useful life of the property. This can be accomplished in one of two ways. First, the \$70,000 investment credit can be set up on the books as a separate asset and depreciated over the 8 years useful life remaining, in addition to continuing the depreciation of the original asset. In this case, the depreciation entries over the remaining 8 years useful life would be as follows:

Dr. Depreciation Expense	\$93,000
Cr. Accumulated Depreciation	\$93,000
Dr. Depreciation Expense	\$8,750
Cr. Accumulated Depreciation	\$8,750

In this manner the full \$1,000,000 original value of the asset will be depreciated—10 entries at \$93,000 = \$930,000 + \$70,000 (8 entries at \$8,750 each). This method is preferred by the majority of practicing accountants with whom the writer has discussed the problem.

A second method of recapturing the unclaimed depreciation would be to restore the original depreciable basis before the investment credit and deduct the total amount of depreciation already expensed, depreciating the remainder for the remaining useful life. Following this procedure, in the circumstances just used, our new depreciable base for the remaining 8 years would be \$314,000 ($\$1,000,000 - \$186,000 \sqrt{2 \times \$93,000}$), and the annual depreciation entry would be:

Dr. Depreciation Expense	\$101,750
Cr. Accumulated Depreciation	\$101,750

Total depreciation expense under this method would also be \$1,000,000, the full cost of the asset as in the method just illus-

trated. See below:

2 entries @ \$93,000	\$186,000
3 entries @ \$101,750	<u>314,000</u>
Total Depreciation	<u>\$1,000,000</u>

THE CONTROVERSY

The mechanics of accounting for the investment are simple. However, before making these accounting entries, the accountant must make a decision as to the nature of the investment credit. On this point there is wide disagreement within the accounting profession. (It should be noted that subsequent changes in the law have contained no provisions that will help alleviate this controversy.) Some of the questions that confound the issue as to the nature of the credit are as follows: Since one might consider the credit a gift because it reduced the income tax liability, should it be treated as donated capital? Is the credit the same as income since it reduced the tax liability and therefore causes the property owner to have more cash? If the credit represents income, is the income earned when the asset is purchased, or as the asset is used up in the productive process? Is the investment credit a deferred credit? The answers to these questions provide ample basis for different, and opposing points of view of the investment credit by accountants. The net result is the fact that the investment credit is making it even more difficult for the Accounting Principles Board to achieve uniformity in accounting practice when the same set of facts prevail.

Discussions of the investment credit before and immediately following the passage of the law in 1962 evidenced a polarization of members of the accounting profession into two different camps. One group advocated that the investment credit should be treated as a reduction of the cost of the asset acquired, and that it should be reflected in income statements as a reduction of depreciation, thereby increasing income over the life of the asset. The other group advocated that the credits received should be treated as a reduction of income tax expense in the year in which they were received. There would be a reduction in the tax basis of the related assets, thereby permitting the credit to flow through to income in the year the property is acquired.

The arguments advanced in support of these two points of view underscore a more fundamental debate, *viz.*, what is income and when is it earned? Existing accounting practices reflect two broad concepts of income. One is the "all inclusive" concept, which recognizes as income for the period all changes in proprietorship interests during the period. The other is the "current operating" concept, which excludes from net income for the period any material items not related to the period, and any extraordinary or non-recurring transactions that are material in amount.

Advocates of the "all inclusive" concept believe that the omission of material extraordinary items from annual income statements is undesirable. They argue that there would be a tendency for those items to be overlooked in a study of the earnings over a period of years.

On the other hand, the advocates of the "current operating" concept argue that they are concerned about the significance of the income statement to users of financial reports. They point out that many users of financial reports are unable to analyze a statement and eliminate the unusual and extraordinary items that tend to distort it for their purposes. Accountants favoring the immediate flow through of the investment credit to income are predominately advocates of the "all inclusive" concept. Those electing to spread the investment credit over the life of the asset are likely to be supporters of the "current operating" concept. The Accounting Research Bulletins¹ have for years sanctioned various practices in accounting for income, with the result that there are numerous divergent opinions among accountants, and a lack of comparability among financial statements. The Revenue Act of 1962 added fuel to this fire.

Accountants have long sought to remain "behind the scenes" as they performed their services. Their code of ethics prohibits advertising, and provides other restrictions that enable individual members of the profession to remain out of the public eye. Examples of other restrictions affording privacy for the public accountant are as follows: soliciting of clients is prohibited; competitive bids for engagements cannot be submitted; and the accountant must observe a confidential relationship with his client. However, because the investment credit was enacted as public law, and because leading members of the accounting

¹American Institute of Certified Public Accountants, Accounting and Terminology Bulletins, Final Edition, p. 144.

profession were either called upon or felt the urge to speak out publicly on this measure, the profession gained wide publicity. This publicity helped crystallize the opposing views concerning the investment credit held by various members of the profession.

OTHER EXAMPLES OF USE OF THE CREDIT

Lessors and Lessees

Lessors and lessees of qualified property are also eligible to take advantage of the investment credit.¹ The law permits the lessor of qualified property to pass the investment credit on to the lessee, provided the lessee is the first person to use the property for its intended function. The basis of leased property for purposes of computing the investment credit is, if transferred to the lessee before February 26, 1964, the same basis as for the lessor's depreciation, unless the property was constructed by the lessor. If the property was constructed by the lessor, the basis is the fair market value of the property on the date of transfer to the lessee. If the property is transferred to the lessee after February 26, 1964, the basis is the fair market value on the date of transfer to the lessee. In either case, the lessee, must use, as the life of the leased property, the estimated useful life used by the lessor in computing depreciation, regardless of the terms of the lease. The law requires that the lessor

¹Public Law 37-334, 87th Cong., 2nd Sess. (1962), p. 10.

and lessee both sign a statement electing to pass on the investment credit to the lessee. The election may be made on the basis of each individual item of property, or a general election to treat the lessee as having purchased all properties transferred to the lessee during the taxable year of the lessee. The election is irrevocable from the time the statement is filed with the lessee, and must be made on or before the 60th day after possession is transferred to the lessee, or on or before July 15, 1964, whichever is later. The lessor and lessee are required to keep the statement of election as part of their records. The lessor must file with his income tax return a summary statement of all property leased during his taxable year for which the election was made.

Under the provisions of the Revenue Act of 1962, if the lessor and lessee make the election, the deductions otherwise allowable under Section 162 to the lessee for amounts paid or accrued to the lessee, must be decreased. The amount of decrease is determined by dividing the investment credit by the estimated useful life in months and multiplying the result by the number of calendar months in which the leased property was held by the lessee during the taxable year. The following example will make this point clear:

Assumed: Leased property at a basis of \$30,000 in the hands of a calendar year lessee—estimated useful life of 10 years—placed in service by the lessee on June 1, 1963.

Lessee's section 162 deductions are decreased by \$122.50 for the 1963 tax year, computed as follows: $\$2,100 \text{ investment credit} (\$30,000 \times .07) \div 120 \text{ months} = \$17.50 \text{ per month} \times 7 \text{ months} = \$122.50.$

It will be recognized that the above treatment of the investment

credit by the lessee gives him the same benefits as if he were the owner of the property. His actual benefit over the useful life of the leased property is the after-tax portion of the investment credit.

Relief was provided the lessee in the Revenue Act of 1964. That Act stipulated that rent deductions need no longer be reduced by the amount of the investment credit passed through to the lessee by the lessor, as to property placed in service after December 31, 1963. Therefore the lessee gets the same treatment as the purchaser, *i.e.*, he receives the full benefit of the investment credit, not the after-tax portion as formerly. The new law also provides for recovery over the remaining useful life of the asset, past decreases in the lessee's rent deductions.¹ The following example will explain the method of recovering past decreases.

Assumed: Qualified property, with 10 years useful life, at a basis of \$20,000, placed in use by lessee on January 2, 1963. The lessee took the investment credit of \$1,400 ($\$20,000 \times .07$), and reduced his rent deductions for 1963 by \$140 ($\frac{\$1400}{12}$).

Effective for 1964 and later years, no further deductions need be made and the \$140 already deducted can be amortized over the remaining life of the asset, 9 years. $\$140 \div 9 = \15.56 to be added to rent deductions each year for 9 years.

Partnerships

A partnership pays no income tax--rather, its income is passed through to the partners, who report it on their individual returns. Likewise, a partnership's investment credit is passed through to the partners, who take the credit themselves.

¹"New Law Tax Planning," Prentice Hall Federal Taxes, 1964, p. 35502.

Let us first look at a typical business of this type, the XYZ Partnership. Example: During the year, the XYZ Partnership buys \$200,000 worth of new equipment eligible for the investment credit--\$80,000 has an 8-year useful life; \$120,000 a 6-year life. Partners X, Y, and Z own 50%, 30% and 20% interests respectively in the business.

To allocate each partner's share of the above eligible property, by useful life category, the partnership allocates the investment among the partners on a statement attached to its return, Form 1065, as follows:

		Cost of eligible property	
		<u>8 Yr. Life</u>	<u>6 Yr. Life</u>
X	(50%)	\$40,000	\$ 60,000
Y	(30%)	24,000	36,000
Z	(20%)	<u>16,000</u>	<u>24,000</u>
		<u>\$80,000</u>	<u>\$120,000</u>

In order to claim his credit, each partner will fill out Form 3468 (Computation of Credit) and attach it to Form 1040. Following is the amount of tax reduction each partner gets on his own return:

<u>Amount of Qualified Investment</u>		<u>7% Credit</u>
X	\$80,000 (\$40,000 + 2/3 of \$60,000)	\$ 5,600
Y	\$48,000 (\$24,000 + 2/3 of \$36,000)	3,360
Z	\$32,000 (\$16,000 + 2/3 of \$24,000)	<u>2,240</u>
		<u>\$11,200</u>

Normally, the partnership's investment is divided among the partners in the same percentage as are the general profits of the partnership, as in the example above. However, the Internal Revenue Service has ruled that if a special allocation is recognized, the new allocation will control.¹

¹"New Law Problems of Fiscal-Year Taxpayers," Accountant's Weekly Report, June 1, 1964, p. 3.

There are some special circumstances that partnerships must watch for in accounting for the credit. One of these circumstances is a change in the percentage owned by the respective partners during the year. In such a case, the percentage on the date the property is placed in service will govern. Example: Partnership WXYZ, with all partners being equal, invests \$20,000 in qualified Machine A on April 1 and \$20,000 in qualified Machine B on September 1. Assume that Partner W died on June 30, and Partner X bought W's interest as of that date. In this case, the result changes as follows:

	Each partner's share of	
	<u>Machine A</u>	<u>Machine B</u>
W	\$ 5,000	-0-
X	5,000	\$10,000
Y	5,000	5,000
Z	<u>5,000</u>	<u>5,000</u>
	<u>\$20,000</u>	<u>\$20,000</u>

If a partner sells or gives away his interest in a partnership, all or part of his prior investment may be recaptured. For example: A new partnership AB--owned equally by A and B--buys \$30,000 worth of qualified equipment, with 8-year useful life, and each partner takes an investment credit on his share of \$2,900 (\$40,000 X .07). If A sells his share to B at the beginning of the next year, A would be required to repay the entire \$2,900 credit he had taken the preceding year. In addition, B would be unable to pick up the unused credit. This is in consonance with the basic law, and the intent of Congress in providing the law, and is enforced by the Internal Revenue Service.

The \$50,000 annual limit on used property must be watched by

partners, individually, and at the partnership level. For example: Partnership CD pays \$90,000 for qualified used property. It can pass through only \$50,000, of which each partner's share is \$25,000. Further, assume D is also the sole owner of another business which pays \$50,000 for used equipment the same year. D's total cost is now \$75,000 (\$50,000 direct investment and \$25,000 "pass through"). However, D may take credit on only \$50,000 for the year and the \$25,000 excess is lost forever.

Subchapter S Shareholders

Subchapter S Shareholders are the owners of the small, closely held, partnership type of corporation which has elected to be taxed as a partnership under Subchapter S. In a Subchapter S corporation, 100% of the stock is held by a very small number of people, frequently 3 or 4. As with the true partnership, there are special rules for handling the investment credit in the Subchapter S Corporation. Example: A small corporation which has elected to be taxed as a partnership purchases \$100,000 worth of new equipment with a 10-year useful life, and \$60,000 worth with a 6-year life. There are ten shares of stock in the corporation, all outstanding: A owns 5 shares; B owns 3, and C owns 2. The corporation attaches a summary statement to its return Form 1120-s, showing the apportionment of qualified property to each shareholder by useful life category, as follows:

	Useful life category	
	<u>8 yrs. or more</u>	<u>6 or 7 yrs.</u>
Total Cost	<u>\$100,000</u>	<u>\$60,000</u>

(continued)

	Useful life category	
	<u>8 yrs. or more</u>	<u>6 or 7 yrs.</u>
Allocations:		
A (5/10)	\$ 50,000	\$30,000
B (3/10)	30,000	13,000
C (2/10)	<u>20,000</u>	<u>12,000</u>
	<u>\$100,000</u>	<u>\$60,000</u>

The shareholders would each complete a Form 3468 and attach to his personal tax return Form 1040. Following are the computations of the credit for each shareholder:

<u>Useful Life</u>	<u>Cost or Basis</u>	<u>Percentage</u>	<u>Qualified Investment</u>
<u>Shareholder A</u>			
6 or 7 years	\$30,000	66 2/3%	\$20,000
8 or more	\$50,000	100%	<u>\$50,000</u>
			\$70,000
			<u>X .07</u>
Investment Credit			<u>\$ 4,900</u>
<u>Shareholder B</u>			
6 or 7 years	\$18,000	66 2/3%	\$12,000
8 or more	\$30,000	100%	<u>\$30,000</u>
			\$42,000
			<u>X .07</u>
Investment Credit			<u>\$ 2,940</u>
<u>Shareholder C</u>			
6 or 7 years	\$12,000	66 2/3%	\$ 8,000
8 or more	\$20,000	100%	<u>\$20,000</u>
			\$28,000
			<u>X .07</u>
Investment Credit			<u>\$ 1,960</u>

As in the true partnership, if either shareholder has other property qualifying for the credit, it must be included in his computations on Form 3468. In the case of used property, the \$50,000 limit applies first at the corporate level and again at the shareholder level, exactly as in the true partnership.

There is a special rule for allocating among shareholders in the Subchapter S corporation.¹ The rule provides that only shareholders on the last day of a Subchapter S corporation's taxable year are apportioned a pro rata share of the qualified property. Therefore, a new member buying into a Subchapter S corporation toward the end of a taxable year might be in for a windfall, gain or loss. The loss is possible since the corporation's income is taxed only to end-of-year shareholders. It will be noted that this differs from the true partnership where the date the property is placed in service is the governing factor as to whom the investment is passed. Similarly, another precaution is in order--if a shareholder in a Subchapter S corporation disposes of some of his stock, it is considered the same as a disposition of part of the property on which the investment credit has been taken and, if the useful life has not expired, the old shareholder is liable for the unearned credit. It should also be noted that the shareholders are also liable when a Subchapter S corporation sells property on which the investment credit has been taken before expiration of the useful life of the property.²

The appropriate action to take in all possible situations concerning a Subchapter S corporation is not clear at this time. Subchapter S is only about five years old, and the Internal Revenue Service Regulations concerning Subchapter S corporations and the investment

¹"Subchapter S Shareholders," Accountant's Weekly Report, June 22, 1964, p. 1.

²Loc. cit.

credit are not yet complete. Therefore, shareholders and accountants for Subchapter S corporations must proceed with extreme caution concerning the investment credit, at the present time.

Miscellaneous Changes

The Revenue Act of 1964¹ also provides that the investment credit may be taken on certain component parts of buildings that were excluded under the original law. Among those items now covered are (1) elevators and escalators, provided the construction, reconstruction, or erection of the elevator or escalator is completed after June 30, 1963; or the elevator or escalator is acquired after June 30, 1963 and the original use of the equipment commences with the taxpayer after that date; (2) temperature control and humidifying systems which are directly related to the productive process in which the firm is engaged; included would be foodstuffs, textiles and other industries where such equipment is essential to the productive process.

SUMMARY

A large percentage of the research conducted in preparing this article was conducted by the writer through personal interviews with practicing public accountants and one lawyer who specializes in tax work. The five Certified Public Accountants interviewed ranged from the owner of a small two-man office to partners and a managing partner in the Kansas City, Missouri offices of two of the nation's largest

¹"Revenue Act of 1964," op. cit., p. 16.

accounting firms. From these interviews it is concluded that the major issue concerning the investment credit, i.e., the true nature of the credit, has not yet been resolved, nor is it likely to be resolved soon. It can also be concluded from these interviews that the investment credit has been, and is being used as a sounding board for those with opposing views to express themselves concerning the real issue among accountants, i.e., lack of agreement on the basic accounting principles and postulates. Unfortunately, there is no general agreement among accountants as to what the postulates of accounting are. Until and unless these are agreed upon, the accounting principles and procedures will continue to be diverse. One of the basic issues about which there is wide disagreement concerns income, i.e., a definition of income, when is income earned, etc. Inseparably connected with the questions concerning income itself, is the problem of income tax allocation. This has been a vexing and divisive problem for accountants since tax laws have existed in the United States.

When the very body created by the accounting profession to establish uniformity of accounting methods publishes a pronouncement concerning the allocation of income taxes which approves contradictory procedures for accounting for those taxes, there is little wonder that there are so many different methods employed under similar circumstances by different accountants. Accounting Research Bulletin 43 contains such contradictory procedures in Chapter 10, Section B.¹ It is primarily

¹ Accounting and Terminology Bulletins, op. cit., p. 87.

because the investment credit is directly related to the income and income tax allocations of the firm employing the credit that it has proved so controversial. If it were possible to consider the problem of the investment credit without being influenced by the numerous other closely related problems, uniformity in accounting for the credit might be relatively easy to accomplish. However, it would be impossible to so isolate the problem. All of the accountants with whom the writer discussed this matter indicated that the investment credit by and of itself was no great problem. The real problem stems from the fact that the investment credit is simply the latest of a long list of problems concerning income and income tax allocation--problems that had already divided the members of the accounting profession.

The Revenue Act of 1964 has made the laws concerning the investment credit more liberal by making the credit applicable to investments in certain types of equipment that were not eligible for the credit under the original law; and by allowing the investor full benefit of the credit rather than only the portion remaining after taxes. However, nothing has been provided by legislation to settle the controversy concerning the nature of the investment credit. This controversy relates to the basic postulates and principles of accounting, on which the profession is now seeking agreement.

As to the different methods employed in accounting for the investment credit, the accounting profession has only itself to blame for the fact that different methods are being used. The Accounting

Principles Board, in its Opinion No. 4,¹ has indorsed two separate methods of accounting for the credit. With the "quasi" official sanction of more than one method, there is little wonder that there is no uniformity in the accounting. The fact that all the methods being utilized have the same net effect on net income over the useful life of the property should not be used as justification for using an improper accounting method. There should be only one proper method.

It was surprising to learn from practicing accountants that the investment credit is considered to be a material item in such a few firms. It is considered to be a material item with no more than 150 firms across the United States. This also contributes to the lack of uniformity. Presumably, if it is not a material item, the independent auditor could accept almost any method of accounting for the investment credit. However, because of the change contained in the Revenue Act of 1964, providing that the depreciable base need not be reduced, consistency in accounting for the credit might be a problem for auditors in the next few years.

CONCLUSIONS

Although not net income initially, the investment credit reduces the income tax liability and should be reflected in income as it increases net income over the productive life of the asset. This conclusion is

¹Opinions of the Accounting Principles Board, op. cit., p. 22.

based on the following statements:¹

President Kennedy: "The tax credit increases the profitability of productive investment."

Secretary Dillon: "Because it reduces the net cost of acquiring depreciable assets it increases the rate of profitability."

The House Ways & Means Committee: "This reduced cost will stimulate additional investment since it increases the expected profit from their use."

The Senate Finance Committee: "By reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition," and "This will have the effect of increasing the earnings of new facilities over their productive lives."

In each of these instances, the administration and Congress said the greater profitability created was to be realized over the life of the plant to which the investment credit applied. It therefore appears that the "full-deferral" method of accounting for the investment credit is the only proper method.

¹Leonard Spacek, Accounting Treatment of Investment Credit, p. 10.

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INVESTMENT CREDIT

by

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B. S., University of Maryland, 1960

AN ABSTRACT OF A MASTER'S REPORT

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ABSTRACT

Acting upon a recommendation of President John F. Kennedy, the Congress of the United States provided for the investment credit in the Revenue Act of 1962. The stated purpose of the credit is to encourage domestic industry to modernize and expand its productive facilities. The credit is applied as a reduction of the income taxes otherwise payable, and is earned when certain qualified assets are acquired and placed in use. The maximum amount of the credit is equal to seven per cent of the investment in qualified assets having a useful life of eight years or more. Qualified assets having a shorter useful life earn a proportionate share of the seven per cent credit.

As originally enacted, the law provided that the depreciable basis of the property would be reduced by the amount of the investment credit. This part of the law was revised by the Revenue Act of 1964 which provided that the full cost of the asset would be depreciated. The net effect of this change was to grant the property owner the full amount of the investment credit, whereas, under the original law, he realized only the after tax portion of the credit.

Three basic methods are employed by corporations in accounting for the investment credit. These are: (1) the "full deferral" or "cost reduction" method, (2) the "48-52%" or "partial-deferral" method, and (3) the "100% flow-through" or "no-deferral" method. The primary difference between the three methods is the user's concept of when the credit, or income, is earned. All three methods have the same net effect on income over the useful life of the asset. However, the

"full-deferral" method appears to be more in consonance with the intent of Congress in providing the credit, i. e., "...increasing the earnings of new facilities over their productive lives."

The law permits the lessor of qualified equipment to pass the credit on to the lessee. As changed in 1964, the law now includes certain component parts of buildings in the category of qualified equipment: examples are, elevators, escalators, air conditioning equipment when a part of the productive process, and others.

Although a material item to only a comparatively small number of firms, the investment credit gained wide acceptance immediately and, at the same time, became a very controversial matter among accountants. This controversy was not alleviated by the Revenue Act of 1964, and probably will be settled only when the accounting profession resolves the major differences of opinion regarding the basic postulates and principles of accounting.